Cases—Continued

Prudential Ins. Co. of America v. *Securities and Exchange Commission*, 326 F. 2d 383, certiorari denied, 377 U.S. 953 ..... Page 14, 30
Securities and Exchange Commission v. *C. M. Joiner Leasing Corp.*, 320 U.S. 344 ..... 19, 25, 37
Securities and Exchange Commission v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 ..... 17, 31
Securities and Exchange Commission v. *Ralston Purina Co.*, 346 U.S. 119 ..... 16, 37
Securities and Exchange Commission v. *Variable Annuity Life Insurance Co.*, 359 U.S. 65 ..... 9, 10, 11, 12, 13, 14, 15, 16, 17, 18, 22, 24, 26, 27, 28, 29, 30, 31, 32, 37.
Securities and Exchange Commission v. *W. J. Howey Co.*, 328 U.S. 293 ..... 17, 18, 31, 37

Statutes and Rules:

Securities Act of 1933, 48 Stat., as amended, 15 U.S.C. 77a, *et seq.*:
Section 2(1) (15 U.S.C. 77b(1)) 18, 21, 39
Section 3(a)(8) (15 U.S.C. 77c(a)(8)) 13, 29, 33, 39
Section 4 (15 U.S.C. 77d) 18
Section 5 (15 U.S.C. 77e) 2, 18
Section 7 (15 U.S.C. 77g) 18
Section 10 (15 U.S.C. 77j) 18
Schedule A (15 U.S.C. 77aa) 18
Investment Company Act of 1940, 54 Stat. 789, 15 U.S.C. 80a–1, *et seq.*:
Section 2(a)(8) (15 U.S.C. 80a–2(a)(8)) 40
Section 2(a)(17) (15 U.S.C. 80a–(2)(a)(17)) 14, 40
Section 2(a)(21) (15 U.S.C. 80a–2(a)(21)) 40
Section 2(a)(27) (15 U.S.C. 80a–2(a)(27)) 41
Section 3(a)(1) (15 U.S.C. 80a–3(a)(1)) 41
Section 3(a)(3) (15 U.S.C. 80a–3(a)(3)) 41
Section 3(c)(3) (15 U.S.C. 80a–3(c)(3)) 9
Section 7(b) (15 U.S.C. 80a–7(b)) 2
Section 8 (15 U.S.C. 80a–8) 2
Section 10 (15 U.S.C. 80a–10) 20
Section 13 (15 U.S.C. 80a–13) 20
Section 15(a) (15 U.S.C. 80a–15(a)) 20
Section 16 (15 U.S.C. 80a–16) 20
Section 17 (15 U.S.C. 80a–17) 20

Statutes and Rules—Continued
Investment Company Act of 1940—Continued
Page
Section 18 (15 U.S.C. 80a–18) 20
Section 18(i) (15 U.S.C. 80a–18(i)) 20
Section 20(a) (15 U.S.C. 80a–20(a)) 20
Section 27 (15 U.S.C. 80a–27) 20
Section 30(d) (15 U.S.C. 80a–30(d)) 20
McCarran-Ferguson Act, 15 U.S.C. 1011–1015 13
Neb. Rev. Stat. (1963 Cum. Supp.) § 44–310.06 3
Miscellaneous:
Bellinger, Hagmann & Martin, *The Meaning and Usage of the Word "Annuity"*, 9 Journal of the American Society of Chartered Life Underwriters 261 (1955) 24
Blakeslee, *The Regulation of Vraiable Annuities—Pt. II*, Best's Insurance News (Life ed. Nov. 1965) 22
Haussermann, *The Security in Variable Annuities*, Insurance Law Journal (June 1956) 24
Hearings on S. 3580 Before a Subcommittee of the Senate Committee on Banking and Currency, 76th Cong., 3d Sess. (1940) Part 1 19, 29
H. Rep. No. 85, 73d Cong., 1st Sess. (1933) 29
H. Rep. No. 2639, 76th Cong., 3d Sess. (1940) 19, 21
Huebner and Black, *Life Insurance* (6th ed. 1964) 24, 36
Institute of Life Insurance, *Life Insurance Fact Book* (1966) 24
Investment Trusts and Investment Companies, Report of Securities and Exchange Commission, Supplement on "Companies Sponsoring Installment Investment Plans," H. Doc. No. 482, 76th Cong. (1940) 21
Maclean, *Life Insurance* (9th ed. 1962) 24, 36
Mehr and Osler, *Modern Life Insurance* (3d ed. 1961) 24, 36
Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, H. Rep. No. 2337, 89th Cong., 2d Sess. (1966) 22
S. Rep. No. 1775, 76th Cong., 3d Sess. (1940) 19, 21
Securities and Exchange Commission 31st Annual Report 21

In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 428

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

UNITED BENEFIT LIFE INSURANCE COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

OPINIONS BELOW

The oral ruling and the findings and conclusions of the district court (R. I 76–77, 105–107) are unreported. The opinion of the court of appeals (R. I 109–115) is reported at 359 F. 2d 619.

JURISDICTION

The judgment of the court of appeals was entered on March 10, 1966 (R. I 116). On June 9, 1966, the Chief Justice extended the Commission's time to file a petition for a writ of certiorari to July 8, 1966, and on July 7, 1966, Mr. Justice Stewart further extended the time for petitioning to August 8, 1966. The petition was filed on the latter date and was granted on October 24, 1966 (R. I 119). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the insurance exemptions to the disclosure and regulatory provisions of the Securities Act of 1933 and the Investment Company Act of 1940 encompass a "Flexible Fund Annuity" contract under which the value of the purchaser's interest during the accumulation period and the size of the annuity available at maturity depend in significant part upon the value of a portfolio of securities managed by the respondent.

STATUTES INVOLVED

The relevant provisions of the Securities Act of 1933, 48 Stat. 74, as amended, 15 U.S.C. 77a, *et seq.*, and the Investment Company Act of 1940, 54 Stat. 789, 15 U.S.C. 80a–1, *et seq.*, are set forth in the Appendix, *infra*, pp. 39–41.

STATEMENT

1. The Securities and Exchange Commission instituted this action in the United States District Court for the District of Columbia to enjoin respondent (a) from offering and selling securities in violation of the registration requirements of Section 5 of the Securities Act of 1933 (15 U.S.C. 77e), and (b) from engaging in activities enumerated in Section 7(b) of the Investment Company Act of 1940 (15 U.S.C. 80a–7(b)) without registering its "Flexible Fund" pursuant to Section 8 of the Act (15 U.S.C. 80a–8) (R. I 5–21). At issue is the applicability of these statutes to respondent's "Flexible Fund Annuity" program, which may be briefly described as follows:

A purchaser of a Flexible Fund contract makes fixed periodic payments to respondent, a company predominantly engaged in the life insurance business. Respondent undertakes to pool these amounts, after certain specified deductions for sales and administrative expenses,[1] with amounts received from other purchasers of such contracts in a separate account called the "Flexible Fund" or "Flexible Fund A" (PX 2, 3; R. II 3, 13).[2] The assets of the Flexible Fund are invested by respondent in securities, consisting largely of common stocks (PX 3, 8B; R. II 12, 15, 70). The portfolio is administered by respondent, and securities are bought or sold in accordance with the investment judgment of its management (PX 2, 3; R. II 8, 15). The Fund is reduced each month by a fixed charge aggregating approximately 1 percent per year[3] and by an indeterminate charge for income taxes related to the Fund (PX 2, 3; R. II 3, 13; R. I 98).

---

[1] Fifty percent of the first year's payments is deducted, 9½ percent is deducted in each of the following nine years, and 5 percent in each year thereafter (PX 2, 3; R. II, 3, 13).

[2] Special enabling legislation in Nebraska, where respondent is incorporated (R. I 105), permits respondent to establish and administer such a separate account. The statute permits income and gains or losses on such an account to be credited or charged to amounts allocated to it "without regard to the other income, gains, or losses of the company." Neb. Rev. Stat. § 44–310.06 (1963 Cum. Supp.).

[3] The 1 percent charge was selected by respondent in light of its estimate that investment expenses and the cost of meeting the mortality and minimum cash value guarantees will each average approximately one-half of one percent of the asset value of the Fund (R. I 98).

The net asset value of the Fund, as computed each month, fixes the value of each purchaser's pro rata share in the assets of the Fund (PX 2, 3; R. II 3, 13).

The purchaser continues making payments until a "maturity" date selected by him when he first enters into the contract (subject to subsequent change within certain limitations) (PX 2, 3; R. II 2, 4, 18, 19). At any time during the period prior to maturity (the "pay-in" period), he has the option of surrendering his contract and receiving the accumulated value of his interest in the Fund. If he dies during this period, his beneficiary receives either the accumulated value of his interest or a refund of the total of his payments theretofore made, whichever is larger (PX 2; R. II 2, 3).

At the maturity date the contract holder ceases to participate in the Fund. He may then elect to receive the value of his interest in the Fund in cash. Alternatively, he may apply it to the purchase of an annuity under which he receives fixed monthly payments for the remainder of his life (the "pay-out" period). The size of the payments under the latter election is determined by applying an annuity table set forth in the contract (PX 2; R. II 2, 5) to the value of the contract holder's interest in the Fund on the maturity date. Since the contract holder has no interest in the Fund once the pay-out period begins, the annuity payments are fixed in amount as of the maturity date and do not fluctuate with subsequent changes in the market value of the Fund's portfolio.

In addition, the contract contains a "minimum cash value" provision under which respondent guarantees that if the accumulated value of the contract holder's interest at the time he withdraws from the Fund, whether at or before maturity, is less than a certain minimum amount, respondent will make up the difference. The guaranteed minimum is stated in terms of a percent of "net premiums," *i.e.*, the purchaser's gross payments less the stated deductions (see note 1, p. 3, *supra*), and assures a purchaser that a percentage of his "net premiums," ranging from 50 percent in the first year to 100 percent after payments for ten years have been made, will be available upon withdrawal, either to be taken in cash or to be applied to the purchase of a fixed-dollar annuity (PX 2; R. II 3).[4]

The guaranteed percentages of "net premiums" were selected on the basis of statistical studies conducted by respondent prior to offering the Flexible Fund contract. The studies demonstrated that those percentages were sufficiently low as to create no signifi-

[4] Since "net premiums" are a variable percent of total purchase payments, the guaranteed cash value may be expressed as a percent of the total payments. That guaranteed percent changes over the pay-in period as follows:

Total purchase payments	*Guarantees expressed as a percent of total purchase payments*
1 full year	25.0
2 full years	38.6
3 full years	46.2
4 full years	52.2
5 full years	57.7
10 full years	86.5
15 full years	89.3
20 full years	90.7

In later years, the guarantee approaches, but does not reach, 95 percent of total purchase payment.

cant likelihood that the guarantee would be called into play.[5]

Respondent's sales brochure, its other advertising, and the sales materials it furnishes to its representa-

[5] Respondent made elaborate studies of the history of the securities market over an 80-year period from 1880 through 1960 (PX 16A, -B, -C, -D, -E, and 17; see R. I 64–73, 101, II 111–33). One of the studies (PX 17; R. I 70–73, II 118, 130–133), covering the period 1933 through 1960 (R. I 71), applied the 9 worst annual percentage drops (occurring in periods ranging from 1 through 9 years) in stock prices to a hypothetical fund composed entirely of Moody's list of 125 industrial common stocks to determine what the cash value of such fund would have been at the end of each of the periods. From this study respondent compiled the following table (R. II 131):

Worst Drop in Averages over the Period	Cash Value at End of Period	Suggested Guarantee
	Percent of net premium	*Percent*
1 year	51.6	50
2 years	67.2	55
3 years	74.3	60
4 years	75.3	65
5 years	71.5	70
6 years	74.4	75
7 years	84.2	80
8 years	93.1	85
9 years	99.6	90
10 years	----	100

Thus, on only one hypothesis (the worst drop in common stock averages over any 6-year period) would the "Suggested Guarantee" have resulted in any liability from the operation of a purely common stock fund starting in 1933, and even that would have been a liability of only 6/10ths of 1 percent of the net amount paid in—*i.e.*, the difference between the cash value and the guarantee. It is apparent that, had the hypothetical fund contained both fixed income securities and common stocks—as is the case with the Flexible Fund—(see PX 14; R. I 93), no liability under the "Suggested Guarantee" would ever have been incurred at any time during the period covered by the study (see R. I 68–70; PX 17, R. II 121). The guaranteed minimum percentages subsequently incorporated in the Flexible Fund contract (PX 2; R. II 3) were identical to the "Suggested Guarantee" in the table above.

tives for use in soliciting the public repeatedly stress the potential for growth offered by participation in the Flexible Fund's portfolio of securities. The sales brochure (which each purchaser declares in his application that he has read) describes investment features of the Flexible Fund contract—features designed to induce prospective purchasers to enter into the contract on the expectation that it will produce results far exceeding the fixed accumulation provided by tradition annuities (PX 2, 3; R. II 8, 10–20). The Flexible Fund contract is described as providing a modernized method of capital accumulation that gives an opportunity for greater return through participation in a separate fund invested largely in common stocks, thus affording the contract holders a chance to share in the growth of the country's economy (PX 3; R. II 12).

Respondent's newspaper advertisements have proclaimed that the Flexible Fund contract offers "New Opportunity for Financial Growth!" (PX 6; R. II 26). Respondent has furnished its agents with a kit of visual aid sales materials (PX 5; R. II 21–25) for use in soliciting purchasers of the Flexible Fund contract (R. I 79). These materials are designed to substantiate the sales pitch with colorful headlines, charts and graphs. The Flexible Fund contract is represented as providing "features never before combined in a single plan" including "OPPORTUNITY FOR GROWTH" with interest and dividend earnings compounded through reinvestment and "Appreciation in values" (R. II 22). A list of the Fund's initial investments is superimposed upon a background of

symbols and trademarks of leading blue chip corporations commonly identified with investment success and capital growth, *e.g.*, GM, duPont, IBM, AT&T, ALCOA, USS, 3–M Company, TEXACO, GULF, Kodak, GE, and Dow (R. II 23).

Under the heading of "INVESTMENT MANAGEMENT" the sales brochure tells the prospective purchaser that "The Investment Committee consists of professional investment men who for years have had the responsibility for the investment of millions of dollars of the Company's assets" and that "*a Flexible Fund Annuity gives you the Benefit of full-time professional investment managment*" (PX 3; R. II 15). What this experienced investment management might accomplish for the prospect through a combination of skillful selection of investments and favorable market conditions over a period of years is illustrated by graphs and tables (PX 3, 5; R. II. 16, 24, 25). Thus a graph in the brochure shows that payments under the contract of $100 a month for 25 years between 1937 and 1961 would have appreciated from approximately $27,500 (the amount of "net premiums") to more than $180,000 if the Fund had been invested so as to grow at the rate of the Dow Jones Industrial Averages during those years (PX 3; R. II 16).

2. At the conclusion of the Commission's evidence, respondent moved to dismiss the complaint on the ground that the "Flexible Fund Annuity" was "an insurance product" and was therefore exempt from the regulatory provisions of the Securities Act of 1933 and the Investment Company Act of 1940 (R. I 103–104). The district court entered findings of fact, among which was the following (R. I 105):

> 5. Under the guaranteed minimum cash value provision in the FFA policy the defendant guarantees to the annuitant a fixed dollar equal monthly retirement income after the maturity date is reached which income cannot be outlived and the defendant thereby assumes the investment risk involved in that guarantee.

On the basis of this finding, the district court concluded that respondent had, in light of this Court's decision in *Securities and Exchange Commission* v. *Variable Annuity Life Insurance Co.*, 359 U.S. 65, assumed a sufficient share of the investment risk to qualify the contract as an "insurance product," and it dismissed the complaint (R. I 106–107).

The court of appeals affirmed, holding that "United has assumed not only a substantial part, but by far the major part, of the investment risk over the duration of the entire policy. The obligations of United under the FFA, unlike those of the variable annuity, are stated, in large part, in terms of guaranteed dollar amounts; there is a substantial and meaningful 'floor' to the FFA policy" (R. 114–115).[6]

SUMMARY OF ARGUMENT

A. Both the Securities Act of 1933 and the Investment Company Act of 1940 exempt "insurance" from their disclosure and regulatory provisions. In *Securities and Exchange Commission* v. *Variable Life Insurance Co.* (*"VALIC"*), 359 U.S. 65, this Court held that a variable annuity contract that guaranteed the purchaser no fixed dollar payments but only payments

[6] The court thus did not reach the Commission's contention that the Fund itself constituted an investment company under the Investment Company Act of 1940. See *infra*, p. 14, n. 8.

based upon his pro rata share of the fluctuating value of a portfolio of securities was a "security" rather than an insurance contract and therefore not within the foregoing insurance exemptions. Although the contract involved in the present case differs in some respects from that involved in *VALIC*, its essential nature is the same: in both situations the customer is being sold, and is knowingly buying, a participation in a pool of equity securities, which he anticipates will increase in value. Thus, the need for investor protection here is just as great as in *VALIC*, and respondent's Flexible Fund contract is similarly subject to the registration and regulatory provisions of the federal securities laws.

B. The Securities Act of 1933 requires full disclosure of the information necessary to enable the purchaser of a security intelligently to appraise the risks involved when he is asked to invest his funds in an enterprise managed by others. The Investment Company Act of 1940 provides additional protections when the investment takes the form of a participation in a managed fund or pool of securities. Respondent's Flexible Fund operates in much the same way, and performs the same functions, as a typical mutual fund selling shares under a periodic accumulation plan. Indeed, respondent's sales literature represents the Fund as a vehicle for investing in the stock market. Construing the insurance exemptions in the light of the purpose they were intended to serve, the kind of interests Congress intended to regulate, and the need for the protections the securities acts were intended to provide, the Flexible Fund contract is not an insurance contract.

The need of the purchasers of Flexible Fund contracts for the protections of the securities laws is demonstrated by the substantial extent to which they forego security in return for the opportunity to participate in the anticipated profits of the Fund's securities dealings. Although respondent's contracts provide certain guaranteed minimum repayments, these guarantees are "substantially less" than the premiums paid, particularly in the early years (R. I 96). Moreover, the Flexible Fund participant, unlike the holder of the usual deferred annuity, has no assured yield on his savings. These characteristics, which enable the Flexible Fund to invest heavily in equity securities rather than the fixed obligations normally held by insurance companies, distinguish the Flexible Fund arrangement from the conventional annuity and demonstrate the inapplicability of the statutory insurance exemptions.

C. The rationale of the insurance exemptions, which Mr. Justice Brennan discussed at length in his concurring opinion in *VALIC* and which led him to conclude that the variable annuity there involved was not insurance, are equally applicable to respondent's Flexible Fund contract and require the same conclusion as to it. As he there pointed out, a conventional annuity is essentially a fixed-dollar obligation, and the holder of such an annuity is adequately protected by traditional State regulation of insurance companies, which is designed to insure that the company remains solvent and able to meet such fixed obligations as they accrue. The interest of a participant in the Flexible Fund or the VALIC variable annuity, on the other hand, fluctuates with the value of a fund of se-

curities, and is therefore not the type of interest that traditional State regulation is designed to protect. Conversely, it is the kind of interest that the federal securities acts were intended to protect.

D. Neither the availability of a fixed annuity at maturity nor respondent's minimum guarantee converts the Flexible Fund contract into a contract of insurance.

Each Flexible Fund participant, upon withdrawing from the Fund at maturity, may take his share of the portfolio in cash or apply it toward the purchase of a standard annuity. The latter annuity—which admittedly is exempt from regulation as an "annuity contract" under the Securities Act of 1933—is distinct from and in no way changes the nature of the interest that respondent sells in the Flexible Fund. It is only the latter interest that the Commission seeks to regulate, and the combination of that interest with a conventional annuity neither converts it into insurance nor obviates the need for federal protection for its purchasers.

Respondent, by guaranteeing that, upon withdrawal from the Fund, a contract holder will receive at least a stated percentage of his aggregate purchase payments undoubtedly assumes some risk. But such risk does not make the Fund contracts insurance. For, as respondent's own studies demonstrate, the degree of risk is minimal, and it is highly unlikely that respondent will ever have to make good on its guarantee. Moreover, notwithstanding the guarantee, if respondent's investments turn out to be unprofitable, the participants stand to lose an appreciable portion of

their "net premiums" as well as the yield their savings might have earned under customary annuity policies. Finally—and most important—the critical question is not whether respondent has assumed a substantial risk, but whether contracts under which the public purchases interests whose value significantly depends upon the investment experience of a portfolio of securities managed by respondent are within the congressional understanding of the term "insurance." We submit that they are not.

ARGUMENT

THE INSURANCE EXEMPTIONS OF THE SECURITIES ACT OF 1933 AND THE INVESTMENT COMPANY ACT OF 1940 DO NOT COVER RESPONDENT'S "FLEXIBLE FUND"

A. INTRODUCTION

The Securities Act of 1933 and the Investment Company Act of 1940 both contain exemptions relating to insurance.[7] Section 3(a)(8) of the Securities Act, 15 U.S.C. 77c(a)(8), exempts from registration "[a]ny insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner * * * of any State * * *". Similarly,

[7] Respondent also claims exemption by reason of the McCarran-Ferguson Act, 15 U.S.C. 1011–1015. The issue involved in the present case is, however, the same under all three acts. As this Court stated in *Securities and Exchange Commission* v. *Variable Annuity Life Ins. Co.*, 359 U.S. 65, 68; "The question common to the exemption provisions of the Securities Act and the Investment Company Act and to § 2(b) of the McCarran-Ferguson Act is whether respondents are issuing contracts of insurance." Accordingly we advance no separate argument as to the McCarran-Ferguson Act.

Section 3(c)(3) of the Investment Company Act, 15 U.S.C. 80a–3(c)(3), excepts from the definition of investment company "any * * * insurance company." An insurance company is defined in Section 2(a)(17) of that Act, 15 U.S.C. 80a–2(a)(17), as "a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner * * * of a State * * *."[8] Of course, "the meaning of 'insurance' or 'annuity' under these Federal Acts is a federal question" (*Securities and Exchange Commission* v. *Variable Annuity Life Insurance Co.* (*"VALIC"*), 359 U.S. 65, 69).

In *VALIC, supra,* this Court held that a variable annuity contract that guaranteed the purchaser no fixed dollar payments but only payments based upon his pro rata share of the fluctuating value of a port-

[8] Respondent itself is clearly an exempt insurance company within this definition since its primary and predominant business is the writing of customary forms of insurance. We urged below, however, that that exemption does not carry over to the separate Flexible Fund which is entirely devoted to a species of variable annuity. See *Prudential Insurance Co. of America* v. *Securities and Exchange Commission*, 326 F. 2d 383 (C.A. 3), certiorari denied, 377 U.S. 953. The courts below did not decide the issue. Since they found that the Flexible Fund contract is an exempt contract of insurance, they did not reach the question of whether the Flexible Fund, as distinguished from respondent, is an investment company within the meaning of the Investment Company Act. If the Court agrees with us that respondent's contracts are not within the insurance exemptions, it should remand the case for the lower courts to decide whether the Flexible Fund itself is an investment company.

folio of securities was a "security" rather than a "contract of insurance" and therefore not within the foregoing "insurance" exemptions. The Court reasoned that since "the concept of 'insurance' involves some investment risk-taking on the part of the company" (359 U.S. at 71), the variable annuity there involved—which "places all the investment risks on the annuitant, none on the company" (*ibid.*)—was not insurance as that term is used in the federal securities laws, even though "[i]n some respects the variable annuity has the characteristics of the fixed and conventional annuity" (359 U.S. at 70).

Respondent's Flexible Fund contract concededly differs from the variable annuity involved in *VALIC* in that it does guarantee to the purchaser a certain fixed amount.[10] The court of appeals reasoned that this guarantee both distinguishes this case from *VALIC,* and makes the insurance exemptions applicable to the Flexible Fund. But the critical inquiry in determining whether respondent's contracts

[10] A further distinction is that although in *VALIC* the amount of the annuity payments continued to fluctuate during the entire pay-out period as the value of the portfolio changed, under respondent's plan the amount of the payments is fixed by the value of the portfolio at the beginning of the pay-out period, and thereafter does not change with changes in the value of the portfolio. As we show below (pp. 32–34), this factor similarly does not convert respondent's Flexible Fund contracts into insurance.

[11] The Commission is seeking to apply the federal securities laws only with respect to the Flexible Fund itself and to the participations that respondent sells in the Fund; we claim no authority with respect to the fixed-dollar annuity that is available to the Fund participant following the maturiy of his contract and his withdrawal from the Fund. Our claim here is thus more limited than our claim in *VALIC*, since there the

are contracts of insurance within the meaning of the exemption provisions [11] is not whether respondent has assumed some risk, as the court of appeals believed, but whether, because purchasers of those contracts directly participate in the investment experience of a pool of securities, they require the same investor protections that were afforded the purchasers of the variable annuities involved in *VALIC*. As this Court explained in *Securities and Exchange Commission* v. *Ralston Purina Co.*, 346 U.S. 119, 127, the "focus of inquiry should be on the need of the offerees for the protections afforded by registration." This, in turn, requires a consideration of the various protections that these statutes provide for investors; and an analysis of precisely what respondent is selling, and what its customers are buying, in the Fexible Fund contract. As we develop below, the need for investor protection here is no less than it was in *VALIC*, and for the same reason: in both situations the customer is being sold, and is knowingly buying, a participation in a pool of equity securities, which he anticipates will increase in value.

The court of appeals' conslusion is subject to two other infirmities. First, as we show below (pp. 23–25, 34–35), the guarantee does not place any significant risk on the company or indeed any *"investment* risk" at all as that term is used in the insurance con-

---

entire annuity plan—during both pay-in and pay-out periods—was held subject to the Acts. The Commission's jurisdiction over the pay-out phase of the plan there rested upon the fact that during that period the value of the purchaser's interest continued to fluctuate with the market value of the company's portfolio.

text. Second, the fact that a variable annuity in which the company assumes no risk is not an insurance contract does not prove the converse, namely, that a variable annuity in which the company assumes some risk automatically is an insurance contract. Thus, even assuming the validity of the ground upon which the court of appeals distinguished *VALIC*, it would not follow that because respondent assumed some risk, its Flexible Fund contracts are "contracts of insurance" and thus immune from regulation.

Moreover, the court of appeals' decision is at odds with the settled rule that the federal securities laws are to be construed "not technically and restrictively, but flexibly to effectuate [their] remedial purposes" (*Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195). Whether contracts like respondent's are covered by those laws depends upon "economic reality"; "the statutory policy of affording broad protection to investors" must not be "thwarted by unrealistic and irrelevant formulae" (*Securities and Exchange Commission* v. *W. J. Howey Co.*, 328 U.S. 293, 298, 301). Consistent with this approach, it has been held that the exemptions to the securities laws are to be strictly construed. *Capital Funds, Inc.* v. *Securities and Exchange Commission*, 348 F. 2d 582, 586 (C.A. 8).

B. RESPONDENT'S FLEXIBLE FUND CONTRACTS ARE THE KIND OF INTEREST TO WHICH CONGRESS INTENDED THE SECURITIES ACT OF 1933 AND THE INVESTMENT COMPANY ACT OF 1940 TO APPLY

1. Both the Securities Act of 1933 and the Investment Company Act of 1940 were designed to provide important protections to persons who invest their

capital in enterprises managed by others. The Securities Act of 1933 requires full disclosure of the information necessary to enable the purchaser of a security intelligently to appraise the risks involved when he makes an investment decision. The Act provides that when securities are offered for public sale a registration statement must be filed with the Commission and a prospectus must be given to each purchaser. The registration statement and prospectus must contain complete financial statements certified by an independent accountant and detailed information as to the type of venture, the capitalization, the use of the proceeds from the offering, the underwriting expenses, the interests of management and promoters in certain financial transactions and numerous additional matters (Sections 4, 5, 7, 10, and Schedule A, 15 U.S.C. 77d, 77e, 77g, 77j, 77aa).

In order to insure that these protections were widely available wherever needed Congress broadly defined the term "security" in Section 2(1) of the Securities Act, 15 U.S.C. 77b(1), to encompass not only the more commonly recognized vehicles of investment, such as stocks and bonds, but also such types as a "certificate of interest or participation in any profit-sharing agreement," an "investment contract," any interest or instrument commonly known as 'security' " and "any certificate of interest or participation in * * * any of the foregoing." In *Securities and Exchange Commission* v. *W. J. Howey Co.*, 328 U.S. 293, this Court, in a passage which it quoted in *VALIC* (359 U.S. at 72 n. 13), stressed the broad reach of this protective statute. It stated that "an investment contract for purposes of the Securities Act means a

contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise." Such a definition, the Court there noted, "permits the fulfillment of the statutory purpose of compelling full and fair disclosure" and "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." 328 U.S. at 298–299. See, also, *Securities and Exchange Commission* v. *C. M. Joiner Leasing Corp.*, 320 U.S. 344, 351.

The Investment Company Act of 1940 provides additional investor protections, beyond the full disclosure requirements of the Securities Act, when the investor's interest takes the form of a participation in a fund or pool of securities.[12] The 1940 Act seeks, *inter alia,* to foster integrity in the management of investment companies, to permit greater participation by shareholders in the affairs of their companies, to provide shareholders with information concerning

[12] Investment companies have been described as essentially "large liquid pools of the public's savings entrusted to managements to be invested." *Hearings on S. 3580 Before a Subcommittee of the Senate Committee on Banking and Currency*, 76th Cong., 3d Sess. (1940), Part 1, p. 33, quoted in H. Rep. No. 2639, 76th Cong., 3d Sess. (1940), p. 6. They "provide a medium for public investment in common stocks and other securities." S. Rep. No. 1775, 76th Cong., 3d Sess. (1940), p. 2.

their companies, to secure adequate and feasible capital structures and to regulate certain practices involved in the sale of investment company shares. For example, the Act imposes various restrictions on the affiliations of investment company directors;[13] contains prohibitions against self-dealing by management;[14] requires that directors be elected by the shareholders[15] and that the investment advisory contract be approved by the shareholders and be subject to termination by them on sixty-days notice;[16] prohibits investment companies from changing their investment policies without shareholder approval;[17] regulates proxy solicitations;[18] requires that investment companies send financial reports to their shareholders at least semiannually;[19] restricts the issuance of senior securities;[20] and regulates the sales charge which may be made on investment company securities sold under periodic payment plans.[21]

2. Respondent's Flexible Fund is designed, offered to the public and operated as a method for the investment of savings in a common enterprise in the expectation of profits through favorable market performance and respondent's investment skill. As the court of appeals recognized (R. I 110), "[u]nlike a conventional annuity * * * United promises that the

[13] Section 10, 15 U.S.C. 80a–10.
[14] Section 17, 15 U.S.C. 80a–17.
[15] Sections 16, 18(i), 15 U.S.C. 80a–16, 18(i).
[16] Section 15(a), 15 U.S.C. 80a–15(a).
[17] Section 13, 15 U.S.C. 80a–13.
[18] Section 20(a), 15 U.S.C. 80a–20(a).
[19] Section 30(d), 15 U.S.C. 80a–29(d).
[20] Section 18, 15 U.S.C. 80a–18.
[21] Section 27, 15 U.S.C. 80a–27.

annuitant will be credited with a proportionate share of the profits which have resulted from the investment and reinvestment of the money in the Flexible Fund." As noted above (*supra,* pp. 7–8), respondent promotes the Fund as an "opportunity to share in the growth of our economy" with the "benefit of full-time professional investment management" (R. II 15). The Flexible Fund contract is an "investment contract" and a "certificate of interest or participation in any profit-sharing agreement" within the meaning of Section 2(1) of the 1933 Act (15 U.S.C. 77b(1)).

Moreover, in significant respects, the Fund is substantially identical to the open-end management companies, commonly called mutual funds, which comprise by far the largest segment of the investment company industry.[22] Mutual funds commonly sell a substantial portion of their shares under periodic accumulation arrangements whose terms are essentially the same as those on which participations in respondent's Flexible Fund are sold. These periodic accumulation plans were of particular concern to both Congress and the Commission at the time of the passage of the Investment Company Act and were discussed in detail in the House and Senate Committee Reports and in the report by the Commission on its study and investigation of investment companies.[23]

---

[22] See Securities and Exchange Commission 31st Annual Report—1965, p. 109.

[23] See H. Rep. No. 2639, 76th Cong., 3d Sess. (1940), p. 8; S. Rep. No. 1775, 76th Cong., 3d Sess. (1940), pp. 8–10; *Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission*, Supplement on "Companies Sponsoring Installment Investment Plans," H. Doc. No. 482, 76th Cong. (1940).

Mutual fund shares, like the participations acquired by investors in respondent's Flexible Fund, represent a proportional share of a portfolio of securities, usually common stocks. As with the plan involved here, mutual fund periodic accumulation plans provide for the payment by investors of specified sums of money at given intervals, and this money, after deduction for sales expenses, is pooled and invested in a portfolio of securities. The mutual fund shareholder, like the Flexible Fund participant, may redeem his interest at any time and receive in cash the value of his proportionate share of the underlying portfolio. The principal aim of the mutual fund shareholder, like that of the Flexible Fund participant, is to invest in the securities markets by entrusting his capital to the company's management with the expectation that its efforts and favorable market trends will result in a profit to him. Indeed, it is well recognized that the variable annuity, of which respondent's Fund is a variant,[24] represents an effort by the insurance industry to compete effectively with mutual funds in a period marked by continuous inflation, rising common stock prices and the extremely rapid growth of mutual funds.[25] The purchaser of a variable annuity should

[24] In *VALIC* the Court identified the two distinguishing features of the variable annuity as follows (359 U.S. at 69): "First, premiums collected are invested to a greater degree in common stocks and other equities. Second, benefit payments vary with the success of the investment policy." Both of those characteristics are features of the Flexible Fund.

[25] See *Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth*, H. Rep. No. 2337, 89th Cong., 2d Sess. (1966), p. 2; Blakeslee, *The Regulation of Variable Annuities—Pt. II*, Best's Insurance News (Life ed. Nov. 1965) 52, 56.

therefore receive the same protections as the purchaser of shares in a mutual fund.

3. The need for these protections is dramatically shown by an analysis of what purchasers of Flexible Fund contracts give up in the way of guaranteed return in exchange for their opportunity to participate in what respondent describes in its sales brochure as "a chance to share in the growth of the country's economy" (PX 3; R. II 12). Like all other investors in equity securities, purchasers of Flexible Fund contracts give up a substantial measure of security for their investment in the hope of obtaining substantial, although more speculative, profits flowing from the success of the Fund's investments—principally common stocks.

In the first place, the minimum guarantee is substantially less than the amount the purchaser pays under the contract—particularly so in the earlier years—and at the outset the purchaser assumes the complete risk for 75 percent of his payments (see *supra*, p. 5, N.Y.).[25a] Although that percentage gradually declines, it does so only as the absolute dollar amount increases. More important, the Fund participants forego any promise of interest on their savings. Of course, the very nature of the Fund—a pool of equity securities—precludes respondent from promising any rate of return on the amounts in-

[25a] Respondent advised the West Virginia Insurance Department (R. I. 96): "Illinois has currently withheld approval because of their impression that holders of such policies participate in gains but not in losses. This is not the situation under our policy, the minimum guaranteed values being substantially less than the sum of the premiums particularly in the early years."

vested; or, to put it the other way, respondent's freedom to invest the Fund largely in equities is directly dependent on its avoidance of any obligation to produce a fixed yield. In contrast, the guaranteed yield, and the fixed-return investment required to meet that guarantee, have been the traditional hallmarks of insurance.[26] As the articles cited by the Court in *VALIC* (359 U.S. at 71 n. 12) make clear, the "fixed return" that the Court found to be fundamental to the assumption of "investment risk" in the "insurance" sense embraces not simply a refund of part or even all of the amounts deposited but an undertaking to pay a guaranteed yield on those amounts.[27] That element is wholly lacking in the Flexible Fund, and inevitably so.

The extent to which Fund participants forego a risk-free return on their savings can be readily seen from a comparison of the Fund's "guaranteed minimum" with the cash surrender value of respondent's ordinary deferred annuity (see PX 7, R. II 27–34). An annuitant who pays $100 per month for 30 years under respondent's ordinary deferred annuity contract

[26] See Mehr and Osler, *Modern Life Insurance*, 570–571 (3d ed. 1961); Huebner and Black, *Life Insurance*, 297–300, 313–322, 390 (6th ed. 1964); Maclean, *Life Insurance*, 61, 91 (9th ed. 1962). United States life insurance companies held assets at the end of 1965 of an aggregate value of $158.88 billion of which $6.26 billion or only 3.9% were in common stocks. See Institute of Life Insurance, *Life Insurance Fact Book* (1966), pp. 67,81.

[27] See Bellinger, Hagmann and Martin, *The Meaning and Usage of the Word "Annuity,"* 9 Journal of the American Society of Chartered Life Underwriters 261, 268 (1955); Haussermann, *The Security in Variable Annuities*, Insurance Law Journal, June 1956, pp. 382, 387.

is guaranteed $54,828 at its maturity; the guaranteed value after a like number of payments under the Flexible Fund contract is only $33,174, or $21,654 less. Indeed, as the table set forth in the footnote shows,[28] after thirty years the Flexible Fund participant's guarantee is $36,297 less than the amount he would receive by making like payments to a savings and loan association (at 4 percent compounded quarterly) and $2,826 less than he would have from putting the same amount monthly in a safe. It is unreasonable to suppose that respondent's customers would thus forego $20,000 or $30,000 in savings except in the belief that they might thereby gain appreciably through participation in the stock market under respondent's management.

That the Flexible Fund contract is offered as a medium for investment in the stock market, subjecting the purchaser to its attendant risks, is strikingly demonstrated by respondent's own sales literature. The courts below gave no weight whatever—indeed, they apparently did not even consider—these sales materials, notwithstanding the admonition by this Court in *Securities and Exchange Commission* v. *C. M. Joiner Leasing Corp.*, 320 U.S. 344, 352–353, that in determining whether a particular document

[28]

Years	Paid in	Flexible fund guarantee	Respondent's standard deferred annuity (R. II 27)	Savings and loan association 4 percent compounded quarterly
1	1,200	300	624	1,226
5	6,000	3,461	5,460	6,650
10	12,000	10,374	12,504	14,764
20	24,000	21,774	30,792	36,745
30	36,000	33,174	54,828	69,471
40	48,000	44,574	87,156	118,197

or offering is within the scope of the Securities Act, "the test * * * is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect," because "[i]n the enforcement of an act such as this it is not inappropriate that *promoters' offerings be judged as being what they were represented to be*" (emphasis added). This test, applied to respondent's sales literature, leaves no doubt that the Flexible Fund contract is offered to the public upon respondent's representation that it is a vehicle for investing in the stock market.

As noted, the contract is described as providing "a chance to share in the growth of the country's economy" (PX 3; R. II 12). There is a graph depicting the rising trend of the Dow-Jones Industrial Averages (PX 3; R. II 16), and there are tables which show, for example, a 30-year accumulation totalling more than eight times the amount of the purchaser's payments into the Fund (PX 5; R. II 25). In sum, respondent's sales pitch confirms what reason and common sense suggest: the inducement to purchase the Flexible Fund contract is the prospect of speculative gain—and not the certainties of insurance.

C. CONGRESS DID NOT INTEND THE INSURANCE EXEMPTIONS TO COVER THE KIND OF INTEREST ACQUIRED BY FLEXIBLE FUND PURCHASERS WHO REQUIRE THE SAME PROTECTIONS AS THE PURCHASERS OF THE VARIABLE ANNUITIES INVOLVED IN *VALIC*

1. Although the majority opinion in *VALIC* found it unnecessary to decide anything more than that an "annuity" contract which "places all the investment risks on the annuitant, none on the company" (359

U.S. at 71), is not insurance, Mr. Justice Brennan in his concurring opinion (in which Mr. Justice Stewart joined) set forth in considerable detail the reasons why a variable annuity is not "the sort of investment form that Congress was * * * willing to leave exclusively to the State Insurance Commissioners" when it enacted the securities laws (359 U.S. at 76). Those reasons are equally applicable to respondent's Flexible Fund. "[I]n the case of a traditional life insurance or annuity policy," he noted, "the obligations of the company were measured in fixed-dollar terms" and "the investor could not be said, in any meaningful sense, to be a sharer in the investment experience of the company" (*id.* at 77–78); traditional insurance companies "were not investing heavily in equity securities and holding out the possibilities of capital gains through fund management * * *" (*id.* at 79–80). Under these circumstances, he concluded, traditional state insurance regulation of reserves and solvency—a form of regulation designed to make certain that fixed obligations will be met as they accrue—provided meaningful protection for the policyholder and presumably was regarded by Congress as obviating the need for the type of protections afforded by the securities laws.

But when the investor has an interest that fluctuates with the value of a fund of securities, the protections of the federal securities laws are vital, and those afforded by the customary State regulation are relatively meaningless. As Mr. Justice Brennan pointed out (359 U.S. at 78), "the historic functions of state

insurance regulation", to which Congress deferred, are "perfectly circular to the extent that there is no obligation to pay except in terms measured by one's portfolio," since such State regulation is designed to assure the insurer's capacity to meet fixed claims by controlling the adequacy of reserves and the safety of investments thereby, in effect, assuring that "the investor in an annuity or life insurance company *not* become a direct sharer in the company's investment experience." Where, by design, the investor is a participant in the company's investment experience and "the coin of the company's obligation is not money but is rather the present condition of its investment portfolio * * * the federally protected interests in disclosure to the investor of the nature of the corporation to whom he is asked to entrust his money and the purposes for which it is to be used become obvious and real" (*ibid.*). Noting that the variable annuity was unknown when Congress created the insurance exemptions, Mr. Justice Brennan concluded that "even though these contracts contain, for what they are worth, features of traditional annuity contracts,[29] administering them also involves a very substantial and in fact predominant element of the business of an investment company, and that in a way totally foreign to the business of a traditional life insurance and annuity company, as traditionally regulated by state

[29] Mr. Justice Brennan noted that variable annuities "[o]bviously * * * have elements of conventional insurance, even apart from the fixed-dollar term life insurance and the disability waiver of premium insurance sold with some of these contracts (both of which are quite incidental to the main understaking). They patently contain a significant annuity feature * * *" (*id.* at 80).

law. That is what leads to the conclusion that it is not within the intent of the 1933 and 1940 statutes to exempt them" (*id.* at 81).

The legislative history of the securities laws confirms the soundness of this analysis. The House Report on the Securities Act points out that the exempted securities and transactions are those as to which "there is no practical need for * * * [the bill's] application or where the public benefits are too remote." H. Rep. No. 85, 73d Cong., 1st Sess. (1933), p. 5. Referring specifically to the exemption in Section 3(a)(8), the Report states (*id.* at p. 15):

> Paragraph (8) makes clear what is already implied in the act, namely, that insurance policies are not to be regarded as securities subject to the provisions of the act. The insurance policy and like contracts are not regarded in the commercial world as securities offered to the public for investment purposes. The entire tenor of the act would lead, even without this specific exemption, to the exclusion of insurance policies from the provisions of the act, but the specific exemption is included to make misinterpretation impossible.

With respect to the Investment Company Act, the testimony at the Senate hearings on that Act indicates that the exemption for insurance companies was included only because such companies would otherwise fall within the Act by reason of the investment activities which are a necessary part of their ordinary insurance business. See *Hearings on S. 3580 Before a Subcommittee of the Senate Committee on Banking and Currency,* 76th Cong., 3d Sess. (1940), Part 1,

p. 181; *Prudential Insurance Co. of America* v. *Securities and Exchange Commission,* 326 F. 2d 383, 386 n. 3 (C.A. 3), certiorari denied, 377 U.S. 953.

The legislative history is thus persuasive that the purpose intended to be served by the insurance exemptions is a quite limited one. It shows that those exemptions were intended to make certain that an industry which did not present the problems that the acts were designed to ameliorate would not be subject to regulation on purely technical grounds. Since, as we have shown in Point B, *supra,* the Flexible Fund involves precisely the factors that the acts were designed to regulate and, but for the exemptions, would unquestionably be covered, it follows that the Fund is not within the category of interests that Congress intended to define by the term "insurance."

2. Respondent's Flexible Fund involves substantially the same kind of investment as the variable annuity considered in *VALIC* and the purchasers of its contracts require the same protections as the purchasers of the *VALIC* contracts.[30] The Flexible Fund investor, like the investor in *VALIC* or the mutual fund shareholder, acquires an interest or participation in a portfolio of securities in the expectation of profiting from the growth of that portfolio through the investment management and skill of others. Invited to share in the financial experience of a pool of securities, the Flexible Fund participant, like the *VALIC*

[30] Respondent has assured the Colorado Commissioner of Insurance that "we have found rather general acceptance of the word 'Flexible' as having exactly the same connotation as the word 'variable'" (R. I 86).

investor, stands in need of the information and other protections that he can be assured only by application of the disclosure and other requirements of the federal securities law.

The scope of the insurance exemptions is to be rationally construed "in terms of the purposes of the Federal Acts" (*VALIC*, 359 U.S. at 80 (concurring opinion)) and not in a purely nominalistic fashion. Cf. *Securities and Exchange Commission* v. *W. J. Howey Co.*, 328 U.S. 293, 298, 299, 301; *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195. We submit that the insurance exemptions were never intended to exempt a contract which is offered to the public as a medium for investment in the stock market; which provides the purchaser with an interest that fluctuates in accordance with the value of a portfolio of securities; and which operates in the same way, performs the same economic function and presents the same need for the protections of the securities laws as the variable annuity involved in *VALIC*—or, indeed, as a mutual fund.

D. NEITHER THE OPTION TO RECEIVE A FIXED ANNUITY AT MATURITY NOR THE MINIMUM GUARANTEE CONVERTS THE FLEXIBLE FUND CONTRACT INTO A CONTRACT OF INSURANCE

There remain to consider only the two grounds upon which the court of appeals concluded that respondent's contract, unlike the variable annuity involved in *VALIC*, is a contract of insurance. (1) If the investor in *VALIC* elected to receive an annuity at maturity instead of cashing in his interest, he continued to share in the investment experience of the

VALIC portfolio during the payout period, *i.e.*, his monthly income payments varied with the value of the portfolio. The Flexible Fund investor, on the other hand, retains his participation in the Fund only during the pay-in period; the annuity which he may elect to receive at maturity is a conventional fixed-dollar annuity that is payable by the insurance company as such and not out of the Flexible Fund. (2) The *VALIC* contract contained no minimum guarantee.[31]

Neither of these features justifies treating respondent's Flexible Fund as involving an insurance contract.

1. *The option to receive a fixed annuity at maturity*

The option that is available to the Flexible Fund investor to purchase a fixed annuity at the maturity of his contract provides no basis for treating his contract as insurance. Respondent has simply

[31] The provision in the Flexible Fund contract for a refund of all purchase payments in the event of the purchaser's death during the pay-in period affords no basis for distinguishing the present contract from the one in *VALIC*. The contract in *VALIC* included term life insurance coverage for purchasers who were insurable—a feature which this Court referred to as a "true insurance feature" (359 U.S. at 73 n. 15). In contrast, the promise in the Flexible Fund contract to refund all premiums paid in the event of death during the pay-in period is not in the nature of an insurance promise such as a promise to pay the face amount stated in a life insurance policy. It is more like the return of consideration given for a promise which has become impossible to perform—a lifetime annuity obviously can not be paid to a person who dies before reaching retirement age. It should also be noted that the *VALIC* contract contained another conventional insurance feature that is not found in the Flexible Fund contract, namely, a waiver of premiums in the event of the purchaser's disability. See 359 U.S. at 80 (concurring opinion).

attached a standard annuity to its open-end investment plan and given investors the option of purchasing that annuity with the fruits of the investment program. The fixed annuity that is available at maturity is clearly an "annuity contract" within the meaning of Section 3(a)(8) of the Securities Act, and the Commission has never contended otherwise.[32] But that does not mean that the participations which respondent sells in the Flexible Fund—interests which in every way other than the minimum guarantee are virtually the same as mutual fund shares and which terminate at maturity—can be converted into exempt insurance contracts by tacking onto them an optional annuity available at maturity.

In combining a standard annuity with a participation in the Flexible Fund, respondent has done essentially what the Advisers Fund, Inc., a mutual fund registered with the Commission has been doing for years in conjunction with an affiliated insurance company subject to state regulation. The mutual fund's shares are sold on an installment payment plan, coupled with the promise of the insurance company that upon redemption of the shares it will accept the proceeds as payment for an immediate annuity with monthly payments based upon the annuity tables which were in effect during the pay-in period.[33] In short, what a Flexible Fund participant does with his money after he withdraws from participation at the maturity date of his contract and whether or not he elects to buy an ordinary annuity have no bearing

[32] See note 11, *supra*, p. 15.

[33] See the public official files of the Commission, File Nos. 2–10669 and 811–589.

on whether respondent is selling a security rather than insurance in offering the Flexible Fund contract as providing "New Opportunity for Financial Growth!" (PX 6; R. II 26). The suggestion of the court of appeals (R. I 114) that the Commission's analysis improperly fragments respondent's contract ignores the realities of what respondent offers. Since every Flexible Fund participant remains entirely free to take his share of the proceeds of the Fund in cash, the option to apply those proceeds to the purchase of an annuity is hardly part of a unitary, inseverable whole.

2. *The minimum guarantee*

The Flexible Fund contract provides that, upon withdrawal from participation in the Fund the holder shall receive not less than a stated percentage of his aggregate purchase payments. This minimum guarantee undeniably involves the assumption of some risk by respondent.[33a] But we submit that the court of appeals erred in concluding that such risk was substantial, or that it operated to turn the Flexible Fund contracts into insurance.

To the extent that the court's appraisal of the substantiality of respondent's risk was based upon respondent's obligations under the pay-out annuity (R. I 114), it was mistaken for the reasons previously given (*supra*, pp. 32–34). As to the pay-in period, which is the only period in which purchasers participate in the Flexible Fund, respondent, following elab-

[33a] That risk, however, is not "investment risk" in the insurance sense. See, *supra*, p. 24.

orate studies (see *supra,* p. 6, n. 5), has prudently set its guarantee at a level sufficiently low as to make it extremely unlikely that the Fund's investment experience will be so disastrous as to call the guarantee into effect.[34] Respondent has also determined that an annual charge of one-half of one percent of the asset value of the Fund will suffice to meet the unlikely eventuality of liability on the guarantee, in addition to satisfying all death claims prior to maturity.

Moreover, although the level of respondent's guarantee varies very considerably over the life of the contract, the court below did not indicate to which year between issuance and maturity it looked in appraising the substantiality of the risk. In terms of the total payments made by the purchaser, respondent's minimum guarantee is 25 percent after the first year, 57.7 percent after the fifth year and 86.5 percent after the tenth year (see *supra,* p. 5, n. 4). In comparison with what an investor could have obtained by putting his money in a bank or by buying one of respondent's deferred annuities, the percentages guaranteed are even smaller (see *supra,* p. 25, n. 28).[35]

---

[34] Indeed, unless it were extremely unlikely that the guarantee would ever become operative to any substantial extent, state insurance authorities presumably would not permit the Flexible Fund contract to be written. For if respondent were to incur significant liabilities under its guarantee, respondent in satisfying them would have to invade the resources contributed by respondent's regular life insurance and annuity policy holders, since the net payments of Flexible Fund investors go into the Flexible Fund separate account.

[35] The suggestion of the court of appeals that the Flexible Fund may be analogized to a participating annuity (R. I 114–115, n. 11), which is concededly an insurance contract under

Clearly there are an infinite number of possible variations in the allocation of risk between the issuer and the purchaser of a security (or an annuity). A mutual fund that promised to redeem its shares at not less than some small percent of their initial purchase price obviously would not thereby bring itself within the insurance exemptions to the federal securities acts. While we believe that the degree in which respondent has relieved its customers of risk is, by any rational test, too insubstantial to warrant exemption under the acts, we also believe that allocation of

---

the federal securities laws, is unsound. In a participating annuity, a portion of the annual premium may be returned to the purchaser as a "dividend." To be sure, the amount of such "dividend" may depend upon the success of the company's business during the preceding year. But such success primarily relates to the company's insurance operations—its mortality experience, operating expenses, etc.—and not, as in the present case, to increases in the value of a securities potrfolio. Since the bulk of an insurance company's assets traditionally are invested in debt securities, the amount of the participating "dividends" reflects the success of the company's investment program largely in the sense that such "dividends" will be higher if the interest rate on such debt securities is higher than anticipated—and such higher interest rates may well result not from the success of the company's investment program but from a change in interest rates generally. Moreover, to whatever extent the dividends may reflect the company's investment experience, once declared they are the property of the insured, and unlike the payments under respondent's "Flexible Fund Annuity," their amount does not depend upon the future market performance of the company's securities portfolio. See Mehr and Osler, *Modern Life Insurance* (3d ed. 1961), pp. 570–571; Huebner and Black, *Life Insurance* (6th ed. 1964), pp. 294–300, 313–322, 387–390, 392; Maclean, *Life Insurance* (9th ed. 1962), pp. 61, 91–92, 142, 144–145, 154, 169–170, 350–351. See note 26, *supra*, p. 24.

the risk is not a helpful mode of analyzing the problem. Among other considerations, we note that even if this Court agrees with us that here the respondent has not assumed sufficient risk to qualify its Flexible Fund as insurance, further and probably protracted litigation would be required before the extent of the insurance exemption—if any—for variable annuities could be definitively settled. In all events, we submit that the critical question is not the substantiality of the risk, if any, assumed by respondent, but rather whether contracts under which the public participates in the investment experience of a portfolio of securities managed by respondent are within the congressional understanding of the term "insurance."

To sum up: The decision below denies to Flexible Fund participants the significant protections afforded investors under the federal securities acts. In doing so, it frustrates the congressional purpose to regulate arrangements by which the public is invited to entrust its savings to the management of others in the expectation of sharing in speculative gains. Moreover, a denial of statutory protections to Flexible Fund participants involves a rejection of the salutary principles established by this Court in *Joiner, Howey* and *Ralston-Purina* and effectively deprives *VALIC* of most of its practical significance. If respondent's version of the variable annuity is exempt from regulation, virtually any insurance company is free to engage in the sale of shares in investment pools,

without complying with the federal securities acts, merely by making the proceeds of its investment program convertible into ordinary annuities and by offering some minimal guarantee at levels calculated to be largely without hazard. Given the great popularity of mutual funds and similar arrangements, it is to be expected that many will follow where respondent has led and that a large class of investors may well find their savings guarded only by the essentially irrelevant protections of State insurance regulation. We cannot believe that Congress intended to leave so broad a gap in the federal regulatory scheme.

CONCLUSION

The judgment of the court of appeals should be reversed, and the case remanded for further proceedings (see note 8, *supra*, p. 14).

Respectfully submitted.

THURGOOD MARSHALL,
Solicitor General.

ROBERT S. RIFKIND,
Assistant to the Solicitor General.

PHILIP A. LOOMIS, JR.,
General Counsel,

SOLOMON FREEDMAN,
Director, Division of Corporate Regulation,

WALTER P. NORTH,
Associate General Counsel,

JACOB H. STILLMAN,
Attorney,
Securities and Exchange Commission.

DECEMBER 1966.

APPENDIX

1. The Securities Act of 1933 (48 Stat. 74, as amended, 15 U.S.C. 77a, *et seq.*) provides in pertinent part:

DEFINITIONS

Sec. 2. When used in this title, unless the context otherwise requires—

(1) the term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

* * * * *

EXEMPTED SECURITIES

Sec. 3. (a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:

* * * * *

(8) Any insurance or endowment policy or annuity contract or optional annuity contract,

issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia;

* * * * *

2. The Investment Company Act of 1940 (54 Stat. 789, 15 U.S.C. 80a-1, *et seq.*) provides in pertinent part:

GENERAL DEFINITIONS

Sec. 2.(a) When used in this title, unless the context otherwise requires—

* * * * *

(8) "Company" means a corporation, a partnership, an association, a joint-stock company, a trust, a fund, or any organized group of persons whether incorporated or not; or any receiver, trustee in bankruptcy or similar official or any liquidating agent for any of the foregoing, in his capacity as such.

* * * * *

(17) "Insurance company" means a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State; or any receiver or similar official or any liquidating agent for such a company, in his capacity as such.

* * * * *

(21) "Issuer" means every person who issues or proposes to issue any security,

or has outstanding any security which it has issued.

* * * * *

(27) "Person" means a natural person or a company.

* * * * *

DEFINITION OF INVESTMENT COMPANY

SEC. 3.(a) When used in this title, "investment company" means any issuer which—

(1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;

* * * * *

(3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

* * * * *

(c) Notwithstanding subsections (a) and (b), none of the following persons is an investment company within the meaning of this title:

* * * * *

(3) Any bank or insurance company; * * *

U.S. GOVERNMENT PRINTING OFFICE: 1966